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EC 1008

Introduction to Microeconomics

Welcome

- All course material, including lecture slides, will be available on Moodle
 - <http://moodle.city.ac.uk/>
- The **textbook** for this course is John Sloman, *Economics*, Prentice Hall, 2012, 8th Ed.
- Note: will try to keep definitions in red, examples in blue

Lecture 1

Introducing Economics

Learning outcomes

- To explain what economics is about and to outline the economic problem
- To explain and illustrate the concept of opportunity cost
- To analyse how economists work – theoretical/empirical toolkit

What is economics

- The study of how we deal with **scarcity!**
- Scarcity principle – **having more of one good thing, usually means having less of another**
- Every choice is a trade-off
- Resources are limited and wants are unlimited!
 - (there is one fact of nature here and one assumption)
- What resources?

Factors of production

- Land and natural resources
 - The earth
- Labour
 - You
- Capital
 - Machines
- These are the inputs of the productive process
 - All are limited

Choices / trade offs

- As individuals, households and society we have to make tough choices
 - What?
 - How?
 - How much?
 - For whom?

What is economics?

- The study of human behaviour when confronted with scarcity of resources
- What is the best way for society to manage its scarce resources?
- Subject is split into
 - Microeconomics: Concerned with individual parts of the economy – consumers, firms in particular markets
 - Macroeconomics: Concerned with the economy as a whole

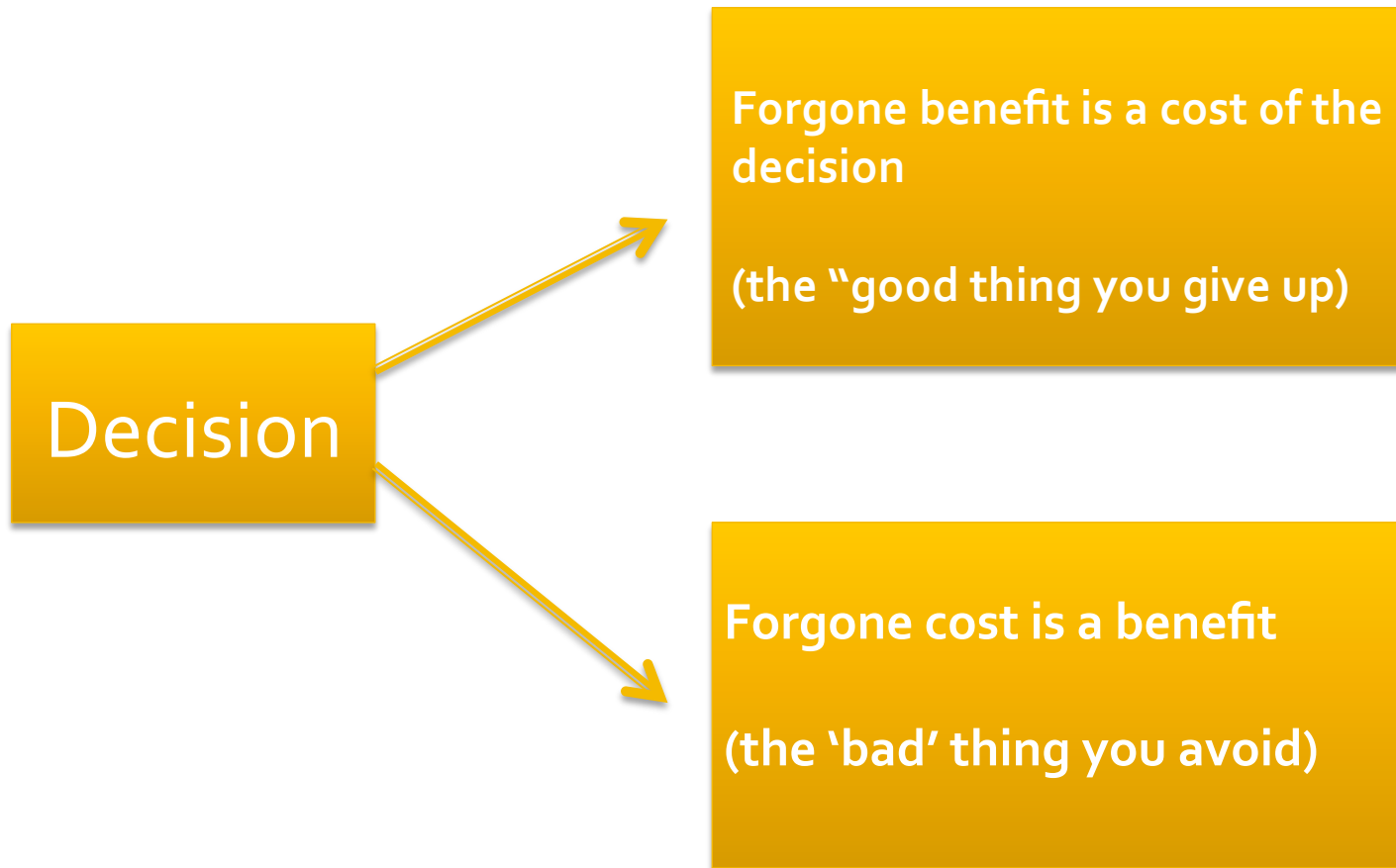
Making choices

- What is the best way of making these decisions for individuals, households and society?
- Economics must have something profound to say on this subject
- Compare the benefits and the costs!
- It sounds so simple but don't be fooled!
- When economists say cost they mean opportunity cost
- Focus on marginal benefits and costs

Opportunity cost

- Easy to define, but often it is surprisingly difficult to apply
- Value of the next best alternative that must be forgone
- Example: Going to the cinema means I cannot go to the museum. What is the value of going to the museum?

Opportunity cost



Some key ideas

- Don't ignore the implicit costs – no actual transfer of money
- Think at the margin – don't focus on the average
 - What matters is not how much you like apples, but how much you want to have *another* apple
- Ignore sunk costs – very counter-intuitive
 - E.g. sunscreen in Alaska
- RationalChoice:
 - Weighing up marginal costs and marginal benefits before making a decision

How does society allocate resources?

- In old times



- In the Soviet Union



How does a democratic free-market society allocate resources?

- Who decides what, how and for whom?
- In most cases it is the combined interactions of millions of households/ individuals and firms
- Decentralised – within limits people are free to make whatever decisions they want
 - If you have the money, you can buy it
- This interaction happens in markets
 - Willingness to pay of buyers
 - Cost of production for sellers

Economic *Science*

- Have to approach issues with a scientist's objectivity
- Scientific method - "dispassionate development and testing of theories about how the world works"
 1. Observation
 2. Devise theories/models that explain or predict observed economic phenomenon
 3. Collect data
 4. Test theory

Developing theories/models

- A model is a fable that can teach us something
 - simplified representation of an aspect of reality (thought experiment)
- Only the key factors are included.
- Factors are excluded by making assumptions.
 - Holding other factors constant (Ceteris paribus)
- **Deliberately** abstract from reality



That's
latin!

Why abstract?

- All scientists, but also everyday thinkers, have to simplify the real world in order to be able to work with it
 - (You probably need a computer the size of the universe, to completely describe the universe)
- Simplify the complex world and make it easier to understand
 - Physics: e.g. calculating the speed of a human falling from a bridge
 - Assume ideal spheres and vacuum
 - Meteorology: half the planet is not actually included in the model

Everyone abstracts

- As in psychology



- So in physics



- So in economics



$$Y=C+I+G$$

Abstraction, done right

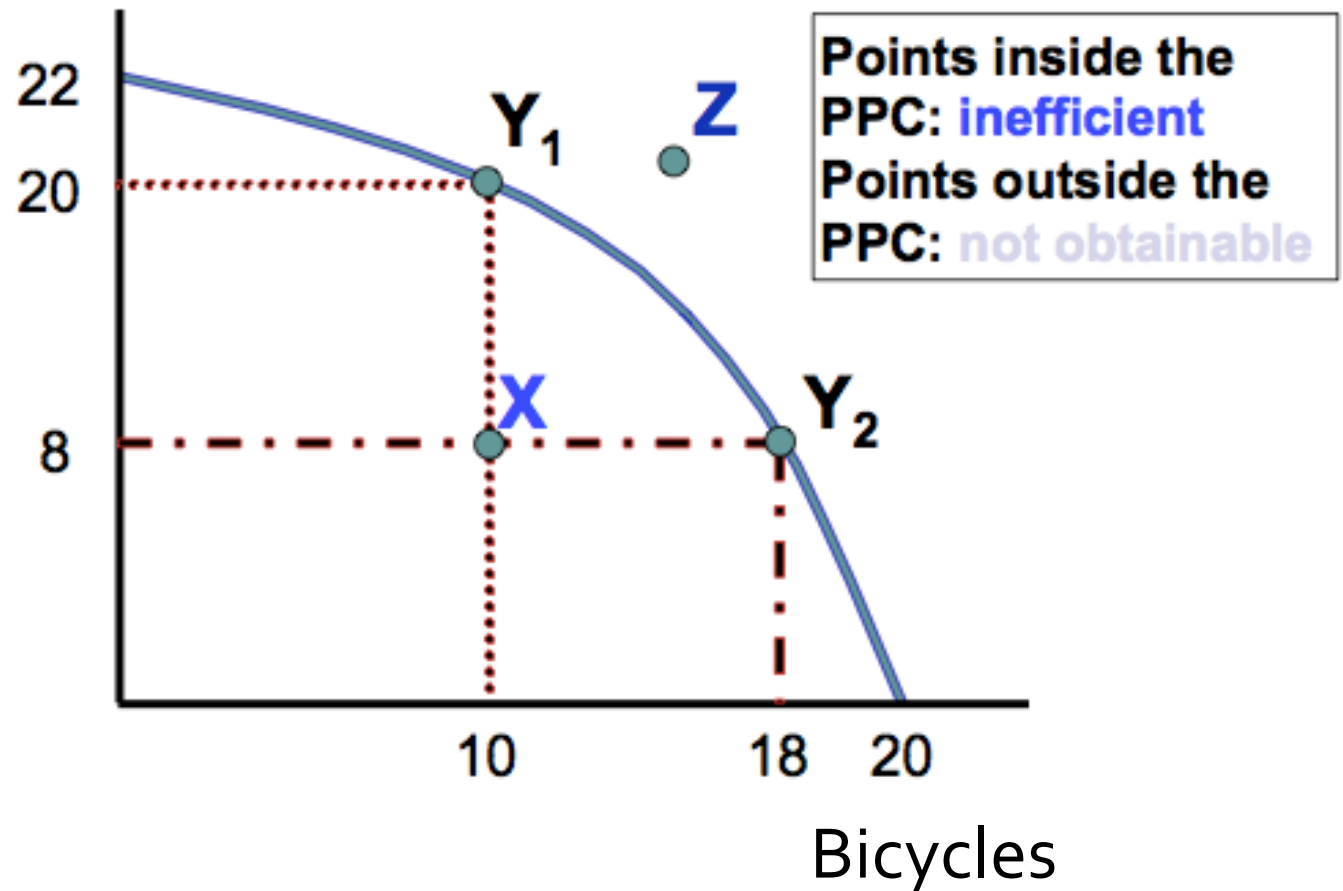
- Helps economists to focus on the key economic relationships
- Enable the influence of *one factor at a time* to be isolated in an imaginary world
- The art is deciding which assumptions to make
- Ignoring details can be useful, just do not ignore the important ones
 - In electron interactions you can ignore gravity, in planetary interactions you can ignore quantum effects
 - When studying saving decisions of US citizens, it is usually OK to ignore supermarkets in Togo

Example: production possibility frontier

- A diagram showing all the possible combinations of two goods that can be produced within a specified time period, with all resources fully and efficiently employed
- Demonstrates
 - Use of models
 - Use of diagrams
 - Idea of trade-offs
 - Concept of opportunity cost

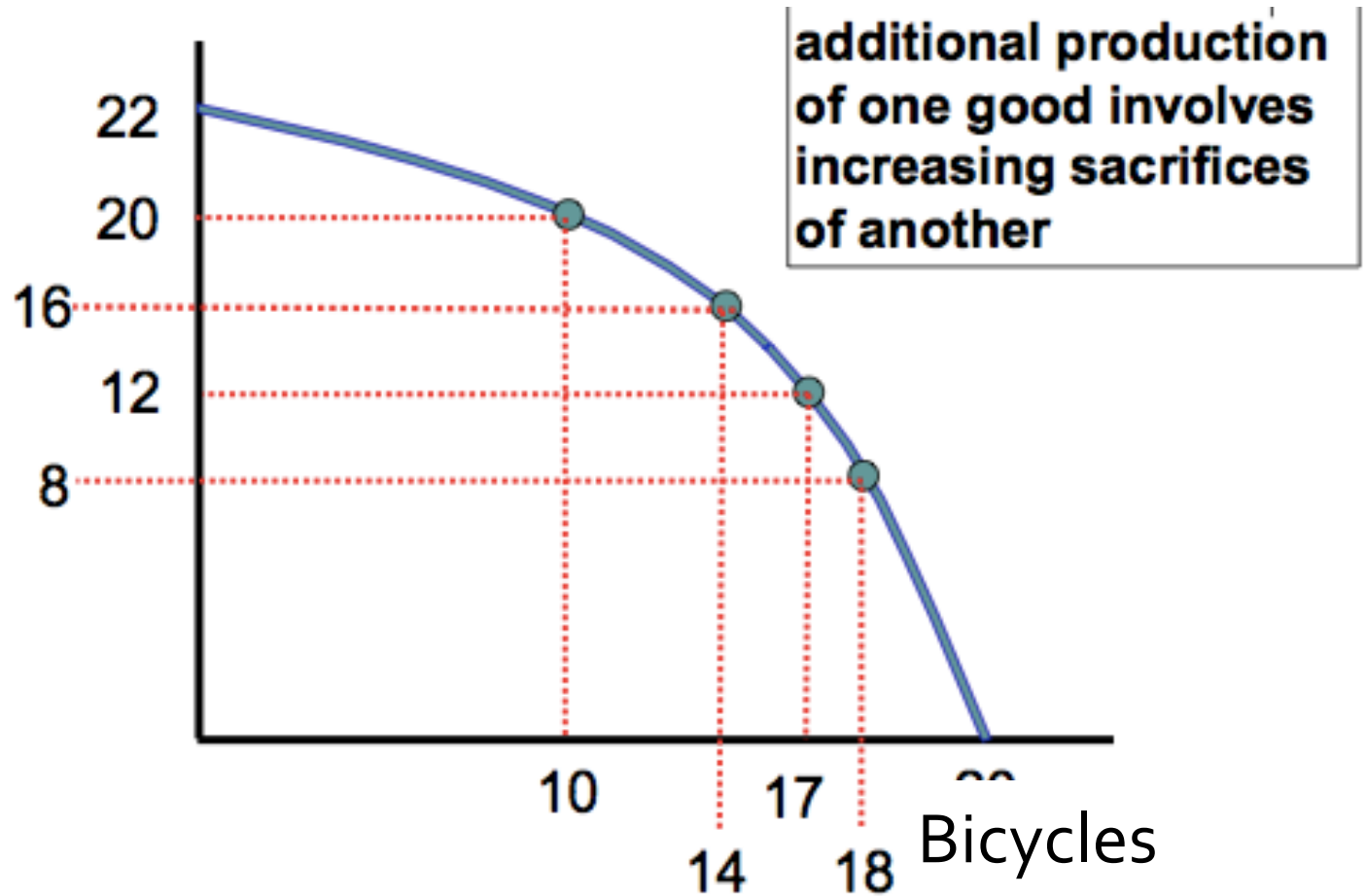
Production possibility curve

BMWs



Increasing opportunity costs

BMW's



How are models judged?

1. Ability to offer insight / help understanding
 - PPF
2. Prediction
 - This will need to be tested against the facts
 - Not judged on how closely the model resembles reality

Testing predictions

- Economists often analyse real world data
- Problem
 - Model contains assumptions – ceteris paribus
 - “demand for ipods goes up if the price goes down”
 - Real world data is determined by the simultaneous impact of many factors
 - People might be buying more ipods because the price went down, or because Rihanna was on TV using one
- Try to isolate the impact of each individual factor
 - Economists use very powerful statistical tools – econometrics
 - Allows to isolate effects and sometimes to verify causality (chicken and egg problem)

Economics and policy

Positive statement

- How the world *is*
- Testable
- Empirical or Logical

Normative statement

- How the world *should be*
- Not testable
- Based on value judgements